



LODI CITY COUNCIL

Carnegie Forum
305 West Pine Street, Lodi

"SHIRTSLEEVE" SESSION

Date: May 2, 2006

Time: 7:00 a.m.

For information regarding this Agenda please contact:

Susan J. Blackston

City Clerk

Telephone: (209) 333-6702

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Informal Informational Meeting

A. Roll call by City Clerk

B. Topic(s)

B-1 Pension issues (CM)

C. Comments by public on non-agenda items

D. Adjournment

Pursuant to Section 54954.2(a) of the Government Code of the State of California, this agenda was posted at least 72 hours in advance of the scheduled meeting at a public place freely accessible to the public 24 hours a day.

Susan J. Blackston
City Clerk



CITY OF LODI COUNCIL COMMUNICATION

AGENDA TITLE: Pension Issues

MEETING DATE: May 2, 2006

PREPARED BY: Jim Krueger, Deputy City Manager

RECOMMENDED ACTION: City Council has requested an analysis of the City's Costs for providing retirement benefits to employees and options for mitigating future cost increases. This has been and will continue to be an important topic of discussion at local, state and national levels. The challenge faced by Lodi in particular is that the cost for providing retirement benefits for City employees has risen from \$2.4 million in fiscal year 2002-03 to an estimated \$ 7.2 million for fiscal year 2005-06. Staff will make a power point presentation to outline the financial challenge the City of Lodi faces in this area and to provide Council with a preview of possible alternatives for resolving these long term issues. Staff invites your comments on possible future Council discussions on this subject.

BACKGROUND INFORMATION: The main reason for this increase in costs is that employer rates have increased from 0% of salaries (as of 2002/03 for both public safety and miscellaneous employees) to 12% and 30% of salaries for miscellaneous and public safety employees respectively (as of 2005/06). The Public Employees Retirement System (PERS) is a defined benefit system. The retirement payout in a defined benefit system is based on a formula that multiplies three factors together. The three factors are: 1) number of years of service, 2) the highest salary over one or three years (one for public safety and three for miscellaneous employees) and 3) a percentage of base salary (3% at 50 years-old [public safety] and 2% at 55 years-old [miscellaneous employees]).

The cost to the employer for funding this retirement payout is based on three factors which vary over the course of time and cause the cost to vary over time as well. The rates paid by employers to fund the payout of the benefits are determined actuarially and take into account, the average age of employees, earnings on the investments held by PERS and any changes in the benefits formula described above. Of these three factors, the one that has resulted in the greatest impact to all cities is that PERS investments suffered losses of \$12.2 billion in 2001 and \$9.7 billion in 2002. These losses were not fully reflected until the employer rates for fiscal year 2005/06 were implemented by PERS. There is very little that employers can do to affect the earnings rates on PERS investments and therefore must take other actions to effectuate a change in the cost for funding the current retirement system. The challenge is to address the areas which the City has some control over the underlying factors contributing towards the rising costs of retirement.

OPTIONS TO MEET THE CHALLENGE

The challenge faced by all California public agencies is to identify areas for which they can control rising costs of retirement. These areas have been identified in the "Pension Reform Task Force of the League of California Cities." The report from this Task Force is attached.

APPROVED: _____
Blair King, City Manager

Following are some options available to mitigate these costs as recommended by the League's Task Force:

- Maintain the deferred benefit plan as the central pension plan for public employees in California and rollback/repeal public retirement plans that provide benefits in excess of levels required to maintain a fair, standard of living that are not financially sustainable and may have no actuarial justification. Subsidiary recommendations to this main recommendation are follows: 1) Offset by 50% the anticipated benefit from Social Security for those employees covered by Social Security; 2) Change the cap amount for highest compensation to 100% for miscellaneous employees; 3) Change the earliest retirement age to 55 for public safety employees.
- Repeal highest "one year compensation" retirement with highest "three years compensation for new public safety employees."
- Provide alternatives to a defined benefit plan for job classifications not intended for career public service employment.
- Give employers greater flexibility to determine when a part-time employee is entitled to public pension benefits.
- Public Agency retirement contribution rates, over time, should be constructed to stay within reasonable ranges around the historical "normal cost" of public pension plans in California. Sound actuarial methods should be adopted to limit contribution volatility while maintaining a sound funding policy.
- Establish "reserve" funding for public pension systems that will help smooth the volatility of pension benefit costs. Plan surpluses are to be retained within plan assets, but should be reserved for amortization of future unfunded liabilities, and should not be used to offset plans' normal cost contribution rates.
- When employer contribution rates exceed the "normal costs" threshold, employees should be expected to take some of the financial responsibility for those excessive increases.
- Full tax-exempt disability retirement should be retained for employees who are injured and can not work in any capacity.
- Reform the disability pension provisions of public retirement systems to restrict benefits when a public employee can continue to work at the same or similar job after sustaining a work-related injury.
- Any pension reform package should retain transferability of retirement benefits across public sector employers. No employee currently in a defined benefit plan should be required to involuntarily give up a defined benefit formula before retirement.
- Any pension reform measures should seek to minimize disparity between current and prospective public agency employees.
- Any reduction(s) or change(s) to current Defined Benefit plans should be considered in context of other compensation issues that will tend, over time, to "equate" compensation plans within and across public agency employers.
- Public agencies that do not make the Annual Required Contribution under GASB 27 should be made subject to appropriate oversight.
- The membership of the Public Employees and Retirement System Board should be changed to achieve both a better balance of employer and employee representatives as well as a better balance of public agency representatives.

CONCLUSION

Many of these options would require that the City of Lodi meet and confer with bargaining units in order to effectuate the changes in accordance with rules associated with negotiating labor contracts with unions. Some require action at a higher level than the City of Lodi. There are also other options to meeting this challenge that were not included in the League Task Force recommendations. For example, one option which City staff would like to bring to Council at a future meeting is the augmentation of retirement benefits for miscellaneous employees by other means such as a 401A plan. Most of the options deal with long-term rate stabilization and cost mitigation measures that may take many years to achieve desirable results. There appear to be no "quick fixes" to this financial challenge. As such, each of these options should be viewed as dealing with the actuarial benefits of mitigating factors that effect the long term employer retirement costs; but which may have little effect on short-term costs.

FISCAL IMPACT: Not Applicable

FUNDING AVAILABLE: Not Applicable

Jim Krueger, Deputy City Manager

Attachments

Pension Reform

History, Analysis, & Options

Prepared by: Janet Hamilton
Management Analyst
City of Lodi

May 2, 2006

Purpose

At the request of the Lodi City Council, staff has prepared this report for discussion of employee retirement benefits and possible options for controlling those costs. Included is the history of public sector retirement benefits, definitions of the various options available to those employees, and data on recent trends in costs for those benefits. The study is global in its analysis, since actuarial projections would require the services of an outside consultant.

An Evolving Pension System

Pension plans established early in the 20th Century were designed to provide retirement income to long-term employees. They helped organizations to retain employees, provided workers a graceful transition to retirement, and helped keep direct compensation and taxes lower. The majority of employee sponsored plans were categorized as Defined Benefit plans (DB), providing a specific amount of compensation at retirement (and explored in more detail later in this paper).

The situation changed dramatically with the passage of the Revenue Act of 1978, which added Section 401(k) plans (or 401(a) for Public Sector employees) to their portfolio of benefits. During the bull market of the 1990s, many employees began to believe that their 401(k) plan would provide a luxurious retirement at an early age. At the same time, financial executives became accustomed to the funding holidays for pension plans delivered by the bull market.

The bear market early in this decade quickly changed these perceptions. Employees now face working longer before their 401(k) plans can provide a comfortable retirement, and executives confront sharply higher contributions and expense for Defined Benefit plans.

The establishment of IRAs and other Defined Contribution (DC) plans, such as the 401(k) plans, substantially increased the resources of the individual to save on a tax-sheltered basis. They provide incentives for employees to save, but they also place the primary burden of retirement planning on the employee.

Employer sponsored pension plans create significant value for both the employee and the employer since they can provide the same benefit for a lower cost than could otherwise be obtained or a greater benefit at the same cost. DB plans create value by pooling risk and purchasing power.

History of PERS (Public Employees Retirement System)

The California Public Employees' Retirement System (CalPERS) was established by state law in 1931 and began providing retirement benefits for state employees in 1932. The City of Lodi began participating in 1966. In the late 1990s, the California legislature enacted benefit enhancements for public employees in the PERS system optional for participating local governments. Many agencies adopted benefit enhancement plans in order to retain employees. When retirement systems subsequently suffered investment losses earlier this decade (see attached report presented to Council in the spring of 2003), those enhancements coupled with the losses to cause substantial increases in employer contribution rates. *(See tables 1 through 4 for 9-year history of rates and contributions for the City of Lodi)*

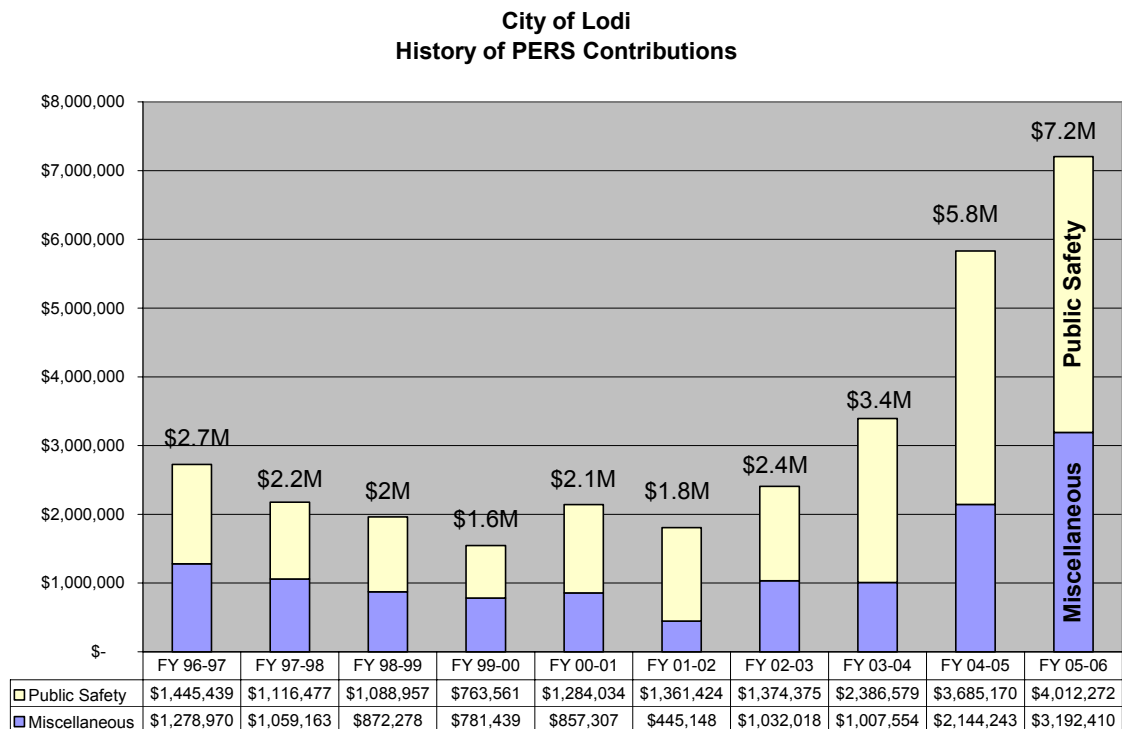


Table 1 (Source: City of Lodi Finance Department)

**City of Lodi
History of PERS Rates
Miscellaneous**

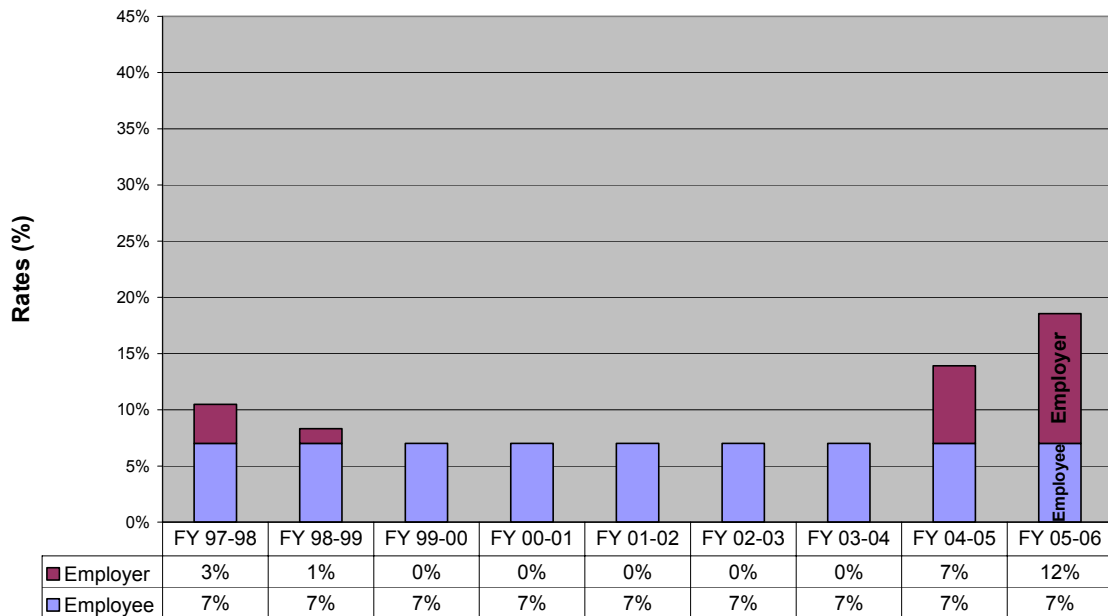


Table 2 (Source: City of Lodi Human Resources Department)

**City of Lodi
History of PERS Rates
Police**

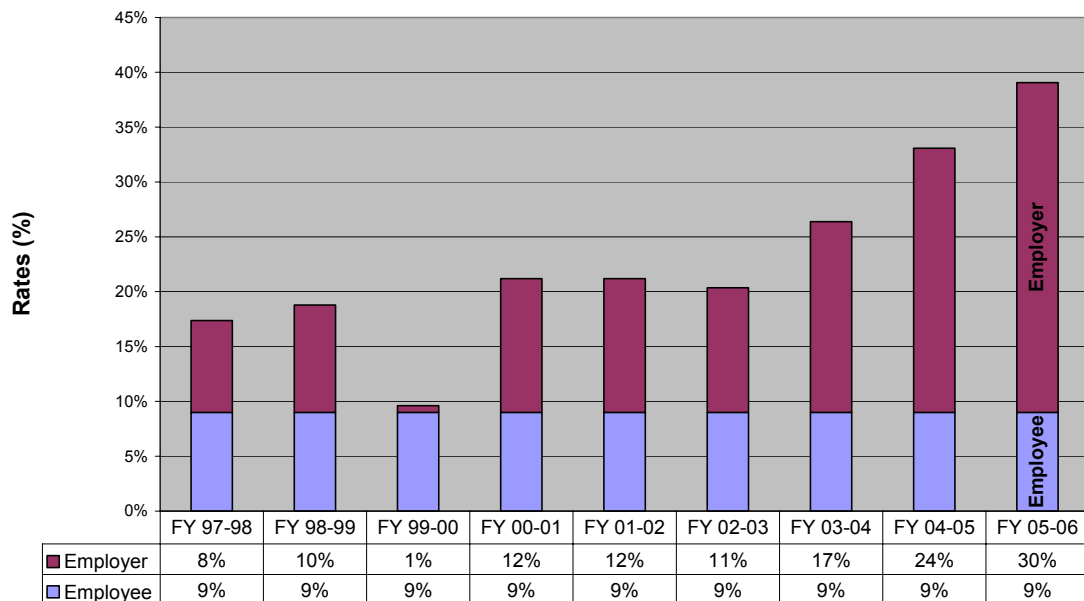


Table 3 (Source: City of Lodi Human Resources Department)

**City of Lodi
History of PERS Rates
Fire**

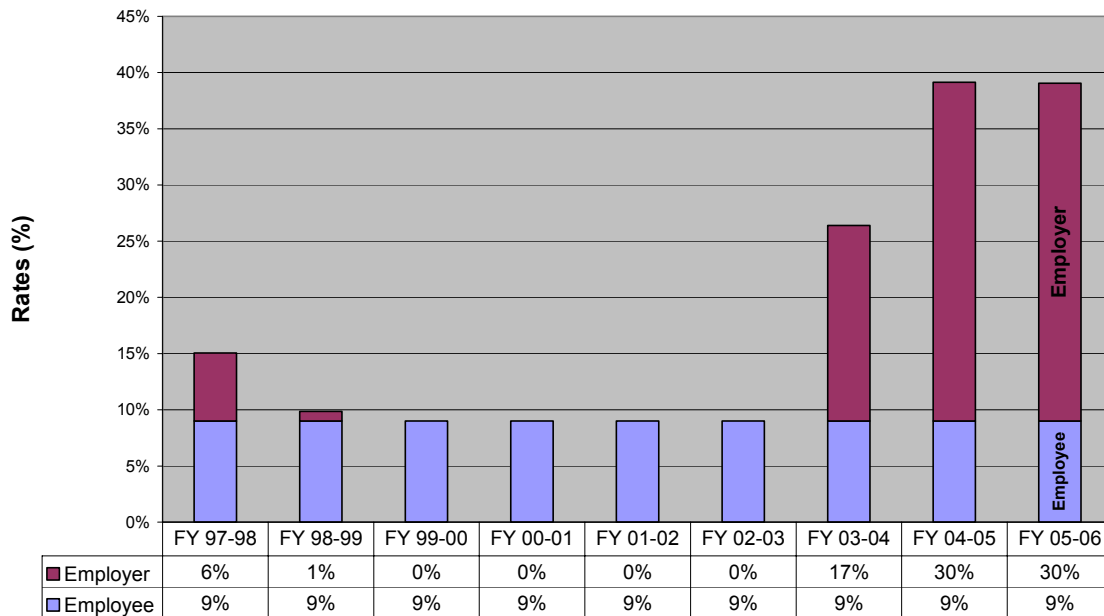


Table 4 (Source: City of Lodi Human Resources Department)

CalPERS manages pension and health benefits for more than 1.4 million California public employees, retirees, and their families. As of June 30, 2005, the agency had collected \$3.2 billion in employee contributions and \$5.8 billion in employer contributions.

CalPERS General Facts			
INCOME TOTALS OVER THE PAST 10 FISCAL YEARS			
Year	Member Contributions	Contributions Employer	Investment and Other Income
2004-05	\$3,176,781,000	\$5,774,120,000	\$21,894,201,000
2003-04	2,266,445,429	4,261,347,422	24,272,572,596
2002-03	1,887,925,497	1,925,043,858	5,482,731,568
2001-02	2,154,742,532	800,964,553	(9,699,792,798)
2000-01	1,766,256,113	321,618,826	(12,248,341,399)
1999-00	1,751,290,172	362,614,344	16,582,657,910
1998-99	1,522,507,527	1,598,316,666	17,622,526,922
1997-98	1,443,232,566	2,289,526,403	23,518,904,869
1996-97	1,379,743,571	1,986,282,287	20,455,866,430
1995-96	1,338,044,978	1,850,103,438	13,137,202,083

Definition of Terms:

Defined Benefit Plans

A Defined Benefit retirement program promises a specified monthly benefit at retirement. The plan may state this promised benefit as an exact dollar amount, such as \$100 per month at retirement, or, more commonly, it may calculate a benefit through a plan formula that considers factors such as salary and service – for example, two percent of average salary for the last three years of employment for every year of service with an employer. It is an employer-sponsored plan for which retirement benefits are based on a formula indicating the exact benefit that one can expect upon retiring. The investment risk and portfolio management are under the control of the managing agency. The employer, the employee, or a combination of the two may contribute to the plan, determined on contract negotiations with employee bargaining groups.

Some agencies have established tiered systems where the employer pays the employees share only after the employee is fully vested. Up to the point of vesting, the employee pays all or a majority share of the employee contribution. In Lodi, the employer pays both shares for all qualified employees, regardless of tenure status. A growing number of agencies have increased the employee's salary base while requiring the employee to be responsible for his/her share of the contribution.

Defined Benefit plans have three main sources of funding – employee contributions, employer contributions, and returns on assets invested by the retirement boards that administer the plans. Investment returns are the biggest component of defined benefit funding.

Employee contributions are typically fixed. Employer contributions usually exceed employee contributions and vary annually depending on returns from assets invested and other factors. Less-than-assumed investment returns require higher future contributions, while returns that exceed expectations result in reduced contributions.

The annual employer contribution for retirement is comprised of two parts – the “normal cost” and the “un-funded liability / actuarial surplus”. The normal cost is the average annual cost of a defined benefit plan. Normal cost contributions collected over the working life of an employee, combined with employee contributions and investment

earnings, should be sufficient to pay that employee's future retirement benefits. For various reasons – such as lower-than-expected investment returns – pension fund assets can fall short of benefit liabilities, resulting in an unfunded liability. Unfunded liabilities are typically addressed through “add-on” employer contribution rates. Retirement plans spread out payment of unfunded liabilities, usually over 10 to 30 years, to “smooth” the impact on these rates.

Defined Contribution Plans

A Defined Contribution plan requires that a specific amount of money be set aside each year for the benefit of the employee. Although the amount contributed is fixed, the retirement benefit will depend on the amount contributed and the performance of the investment. The payoff is not guaranteed. While both the employer and employee may contribute to the plan, most often the employee is responsible for managing the investment. Employer sponsored pension plans generally have a team of investment professionals making all decisions. They are investing millions of dollars compared to the thousands of dollars that individuals invest. Both transaction costs and investment management costs are significantly lower per person than those incurred for individual plans.

Defined contribution plans (401(k) or 401(a) being the most popular) look different. They are like savings accounts. The employer and employee both contribute to the account over the employee's work life. Employees control account assets and can allocate funds amongst investment choices to match their tolerance for risk. Defined contribution assets are also portable, which means that mobile workers can take their pensions with them as they move from job to job. On the other hand, the worker bears the investment risk. Defined contribution plans generally do not pay annuities; rather they offer participants a lump sum. If an employee chooses to do so, they may convert lump sum to an annuity contract.

Defined benefit and defined contribution plans are structured quite differently. Under traditional defined benefit plans, workers accrue benefits over their work life and receive a life annuity at retirement, which guarantees them benefits for as long as they live. The benefit is typically calculated as a dollar amount per year of service or as a percentage of final salary for each year of service.

Pension Reform

The recent volatility in employer rates and rapid increase in contribution levels have spurred much debate and prompted the introduction of measures and initiatives in support of change. The PERS board has recommended a rate stabilization process that would extend the length of time for rate “smoothing”—a technique that reduces volatility over time.

State Assemblyman Keith Richman has introduced ACA 23, which would amend the State Constitution to replace current defined benefit pension plans with a new plan that combines a mandatory defined benefit plan with lower pension benefits and a voluntary defined contribution retirement savings account. In essence ACA 23 would require all government employers offering CalPERS retirement benefits to freeze their existing CalPERS plans and automatically enroll all new employees hired on or after July 1, 2007 into this new retirement plan. This bill has stalled, however, and is not expected to move forward at this time.

League of California Cities Recommendations

The League of California Cities has established a task force on PERS to study the proposals on pension benefit reform. They retained the services of John Bartel of Bartel Associates, LLC, a retirement actuary who worked with Task Force to provide actuarial analyses of their recommendations for reform. His report, entitled *Replacement Ratio Study: Preliminary Results*, can be found on the League of California Cities website, www.cacities.org.

The Task Force report establishes specific principles or goals to be used as guidelines in any effort to reform pension benefits. Some essential goals found in the report include:

- Provide a full-career employee with pension benefits that maintain the employees’ standard of living in retirement.
- Benefit levels should be set with goal of providing a fair and adequate benefit for employees and fiscally sustainable contributions for both employees and taxpayers.
- Benefits should be supported with proper actuarial work to justify pension levels.

- Should be viewed in the context of an overall compensation structure whose goal is the recruitment and retention of employees in public sector jobs.
- Reciprocity of pension benefits within the public sector should be maintained to ensure retention of skilled public employees.
- Perceived abuses of the current DB programs need to be addressed. Benefits should not be excessive but should be appropriate to maintain standard of living.
- Management obligation should be shared by PERS, employer, and employees.

Specific recommendations in regards to pension benefit levels, rate volatility, shared risk, disability retirement, portability of plan benefits, tiered plans, and management oversight are offered. The report concludes with support of defined benefit plans for public sector employees, stating that they “have produced fair and sustainable retirement benefits that have been central to recruiting and retaining quality public employees”.

The full recommendations of the Task Force are attached to this report along with a white paper by the National Association of State Retirement Administrators (NASRA) and other related reports.

PENSION REFORM IN CALIFORNIA
League of California Cities
March 1, 2005

For close to 60 years California state and local governments have offered “defined benefit” retirement plans to their employees which provide a guaranteed annual pension based upon retirement age, years of service, and some period of highest salary (typically the last one or three years of work). These plans generally provide an annual cost-of-living adjustment and additional inflation protection that maintains the purchasing power over time at a specified minimum level. The Public Employee’s Retirement System (PERS), the State Teachers’ Retirement System (STRS), and a variety of individual cities and counties administer these retirement plans.

Over the years local and state government retirement costs have risen and fallen based on two principal factors: (1) the investment returns of the various systems; and (2) the level of benefit payments provided to employees. In the late 1990s the California legislature enacted dramatic benefit enhancements for public employees in the PERS system that were optional for participating local governments. Some local governments adopted these benefit enhancement plans—for a variety of reasons, typically to retain employees and at times at a shared cost with the employees. When the retirement systems suffered serious investment losses in the early part of this decade, these losses combined with the benefit enhancements to cause dramatic increases in employer contribution rates.

Defined Contribution Mandate Proposed

In the fall of 2004 a proposed constitutional and statutory initiative (File No. SA2005RF0007) was filed that would close all state and local public sector defined benefit plans (including locally administered plans) to new entrants effective July 1, 2007. Employees hired after that date could only enroll in defined contribution retirement plans. Defined contribution plans provide fixed annual employer contributions to employee accounts that are invested, along with employee contributions. Unlike defined benefit plans, the employee has no guaranteed pension benefit and employers never incur any unfunded liabilities.

The initiative (which has a legislative counterpart by Assembly Member Richman) would establish maximum employer contributions of 9 percent for police officers and firefighters and 6 percent for other employees, assuming participation in federal Social Security (3 percent higher if no Social Security). Local agencies could exceed these limits with a two-thirds vote of their electorate. The state could do so with a three-fourths vote of both houses of the Legislature in two consecutive sessions. Mr. Richman has informed the League in a letter dated February 17 that he is willing to enter into negotiations to avoid the need for the initiative.

In his 2005 State of the State message, Governor Schwarzenegger recommended a defined contribution pension mandate for new state and local employees. In a presentation to the League board of directors on February 25, 2005 Tom Campbell,

Director of Finance, explained the Governor's proposal contains no caps on employer contribution and would not require lower state or local contributions. It would simply remove the risk of increased costs to the taxpayer due to future stock market declines by requiring that all new state and local employees be provided a defined contribution plan in place of the traditional defined benefit plan. Mr. Campbell indicated that in all other respects (e.g., PERS administration, employer contributions, employer contributions, etc.) the plans would be identical.

League Pension Reform Task Force

In late 2004 the Executive Director asked the City Manager's Department's standing task force on PERS to undertake a study of the defined contribution proposal and potential other defined benefit reforms. A group of other appointed and elected officials were subsequently added to the task force to provide broader input, and since early December it has met regularly to study the problems with the existing defined benefit retirement systems and to evaluate the defined contribution proposal. The task force is chaired by Bob LaSala, Lancaster City Manager.

The League also retained the services of a retirement actuary, John Bartel of Bartel Associates, LLC, who worked with the Task Force to ensure its recommendations for reform of the defined benefit system were actuarially sound. He assisted the Board in its discussions. His report to the Pension Reform Task Force, dated February 26, 2005 and entitled *Replacement Ratio Study: Preliminary Results*, is available from the League.

Review and Comment on Discussion Draft Sought

The task force report was reviewed by subcommittee of the Public Employee Relations Policy Committee on Wednesday, February 23, 2005 and forwarded to the League board of directors with a favorable recommendation. On Saturday, February 26, 2005 the board accepted the report, with modifications, and authorized staff to circulate the report as a discussion draft for review and comment. It is important to note the ideas contained in this report represent an initial assessment by the League on pension reform. It is offered for discussion and consideration in the pension reform debate. Comments are requested from League member cities, other local government associations, local government labor organizations, state legislators and the Administration. Comments should be sent to the League of California Cities, c/o Anthony Thomas, Legislative Representative, 1400 K St., Sacramento, CA 95814 athomas@cacities.org.

A Framework for Public Pension Reform¹

March 1, 2005

General Pension Reform Principles

Any serious discussion of public pension reform must begin with a set of principles/goals to guide any following recommendations. Until questions about the appropriate role and purpose of public pension benefits in local government compensation packages are answered, it would be at least premature and perhaps self-defeating to make any specific benefit recommendations. In keeping with this philosophy, it is recommended that the following principles precede any benefit recommendations:

- The primary goal of a public pension program should be to provide a full-career employee with pension benefits that maintain the employees' standard of living in retirement.
- The proper level of public pension benefits should be set with the goal of providing a fair and adequate benefit for employees and fiscally sustainable contributions for employers and the taxpayers.
- Public pension benefits should be supported with proper actuarial work to justify pension levels. The Legislature should reject any and all attempts to establish pension benefits that bear no relation to proper actuarial assumptions and work.
- Pension benefits should be viewed in the context of an overall compensation structure whose goal is the recruitment and retention of employees in public sector jobs. In recognition of competitive market forces, any change in the structure of retirement benefits must be evaluated in concert with other adjustments in compensation necessary to continue to attract and retain an experienced and qualified workforce.
- The reciprocity of pension benefits within the public sector should be maintained to ensure recruitment and retention of skilled public employees - particularly in light of the retirement of the post World War II "Baby Boom" generation which will result in unprecedented demand for public sector employees.
- Perceived abuses of the current defined benefit retirement programs need to be addressed. Benefit plans which result in retirement benefits which exceed the levels established as appropriate to maintain employees' standard of living should be reformed. It is in the interest of all public employees, employers and taxpayers that retirement programs are fair, economically sustainable and provide for adequate benefits for all career public employees, *without providing excessive benefits for a select few.*

¹ This report constitutes the recommendations of the League Pension Reform Task Force that was accepted by the League of California Cities Board of Directors for distribution as a discussion draft.

- The obligation to properly manage public pension systems is a fiduciary responsibility that is shared by PERS, employers and employees. This joint responsibility is necessary to provide quality services while ensuring long-term fiscal stability. These parties need to be held responsible to ensure a high level of protection against mismanagement of public resources that could jeopardize a community's ability to maintain services and provide fair compensation for its workforce.
- Charter cities with independent pension systems should retain the constitutional discretion to manage and fund such pension plans.

Reform Recommendations

Public employee defined benefit programs have been appropriately criticized in a number of areas. The following reform recommendations address short-comings within some defined benefit retirement programs, while preserving the aspects of the program that have served the employees, employers and taxpayers of California well for over 60 years.

Pension Benefit Levels

Principles: Public pension benefit plans should:

- Allow career-employees to maintain standard of living post-retirement.
- Be designed with consideration of age at retirement, length of service, compensation level and applicability of Social Security.
- Be supported with proper actuarial work to justify pension levels. The Legislature should reject any and all attempts to establish pension benefits that bear no relation to proper actuarial assumptions and work.
- Promote career public service without creating incentives to work past retirement age, nor disincentive to early retirement. Employees who voluntarily choose to either work beyond retirement age or retire early should not be penalized or rewarded.

Recommendations

- Maintain the defined benefit plan as the central pension plan for public employees in California.
- Rollback/repeal public retirement plans that provide benefits in excess of levels required to maintain a fair, standard of living² that are not financially sustainable and may have no actuarial justification. The new and exclusive benefit formulas to achieve these goals should be:

² This should be determined in accordance with a Cal PERS 2001 target replacement benefit study and/or the Aon Georgia State Replacement Ration Study (6th update since 1988).

1. **Safety Employees:** 3% @ 55 formula, offset by 50% of anticipated social security benefit for safety employees with social security coverage. Safety employees retain the current cap on retirement at 90% of final compensation.
 2. **Miscellaneous Employees(Non-safety):** 2% @ 55 formula, offset by 50% of anticipated social security benefit for miscellaneous employees with social security coverage. A cap of 100% of final compensation is placed on newly-hired, miscellaneous(non-safety) employees.
- The above formulas would incorporate “Three-Year-Average” for “final compensation” calculation. All “Highest Final Year” compensation calculations would be repealed for newly-hired employees.
 - Provide alternatives to a defined benefit plan for job classifications not intended for career public service employment.
 - Give employers greater flexibility to determine when a part-time employee is entitled to public pension benefits. The current hourly threshold in PERS is too low.

Rate Volatility

Principles

- Responsible fiscal planning suggests the need to “manage” volatility in defined benefit plan contribution rates.
- Rates have historically been relatively constant and comparable to rates currently paid by most public agency employers.
- Recent rate volatility is primarily due to large fluctuations in annual investment returns for the retirement plan investment portfolios, causing significant changes in plan funding status.
- Normal Costs for defined benefit plans have remained relatively constant over time.

Recommendations

- Public Agency retirement contribution rates, over time, should be constructed to stay within reasonable ranges around the historical “normal cost” of public pension plans in California. Sound actuarial methods should be adopted to limit contribution volatility while maintaining a sound funding policy.
- Establish “reserve” funding for public pension systems that will help smooth the volatility of pension benefit costs. Plan surpluses are to be retained within plan

assets, but should be reserved for amortization of future unfunded liabilities, and should not be used to offset plans' normal cost contribution rates.

Shared Risk

Principles

- Currently, in most local jurisdictions, employers shoulder the burden of rate volatility risk – both positive and negative. This principle should be carefully examined with the intent of better spreading the risk of rate volatility among both employers and employees.
- Negotiated labor agreements containing language whereby employers “pick-up” employees’ retirement contributions are assumed to be part and parcel of a “total compensation” package; this implies that agencies with Employer Paid Member Contributions would also typically reflect correspondingly lower base salaries.

Recommendations

- When employer contribution rates exceed the “normal costs” threshold, employees should be expected to take some of the financial responsibility for those excessive increases.

Disability Retirement

Principles

- Retirement-eligible employees who are injured in the workplace should be entitled to full disability retirement benefits; disability retirement benefits should, however, be tied to individual’s employability and be structured so as to encourage return to work, where applicable.
- Larger disability reform measures should be considered outside of the scope of general pension reform.

Recommendations

- Full tax-exempt disability retirement should be retained for employees who are injured and can not work in any capacity
- Reform the disability pension provisions of public retirement systems to restrict benefits when a public employee can continue to work at the same or similar job after sustaining a work-related injury.

- Employees eligible for disability retirement should be first afforded applicable service retirement benefits, and THEN provided disability retirement benefits up to applicable “cap” on total retirement benefits.

Portability of Plan Benefits

Principles

- Reciprocity of public agency retirement benefits is critical to recruitment of qualified, experienced public sector employees.
- Limiting portability of retirement plan benefits to non-public sector employment helps in the retention of senior and management level employees.

Recommendation

- Any pension reform package should retain transferability of retirement benefits across public sector employers. No employee currently in a defined benefit plan should be required to involuntarily give up a defined benefit formula before retirement.

Tiered Plans

Principles

- Agencies should strive to avoid multi-tiered compensation structures where there are large discrepancies in benefits accruing to employees. In addition to having adverse impacts on recruitment and employee morale, multi-tiered approaches can raise issues of comparable worth and equity.

Recommendations

- Any pension reform measures should seek to minimize disparity between current and prospective public agency employees.
- Any reduction(s) or change(s) to current Defined Benefit plans should be considered in context of other compensation issues that will tend, over time, to “equate” compensation plans within and across public agency employers.

Management Oversight

Principles

- The obligation to properly manage public pension systems is a fiduciary responsibility that is shared by PERS, employers and employees. This joint responsibility is necessary to provide quality services while ensuring long-term fiscal stability. These parties need to be held responsible to ensure a high level of protection

against mismanagement of public resources that could jeopardize a community's ability to maintain services and provide fair compensation for its workforce.

Recommendations

- Public agencies that do not make the Annual Required Contribution under GASB 27 should be made subject to appropriate oversight.
- The membership of the Public Employees and Retirement System Board should be changed to achieve both a better balance of employer and employee representatives as well as a better balance of public agency representatives.

Conclusion

Defined benefit retirement plans have been the traditional approach for close to 60 years in California and have produced fair and sustainable retirement benefits that have been central to recruiting and retaining quality public employees. Defined benefit plans should be retained as the central component of public pension systems in California.

White Paper



National Association of State Retirement Administrators

Myths and Misperceptions of Defined Benefit and Defined Contribution Plans

**November 2002
Updated February 2005**

For questions and comments, contact:
Keith Brainard
NASRA Director of Research
512-868-2774
keithb@nasra.org



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NASRA White Paper

Introduction

Policymakers, public pension plan administrators and others with a political or financial interest are engaged in a debate about the retirement benefits that are provided to public employees. Considering that state and local government pension plans provide benefits for 14 million active employees and hold assets of \$2 trillion, the consequences of this discussion are far-reaching.

Ninety percent of state and local government employees participate in a defined benefit (DB) pension plan. A movement has unfolded in recent years calling for defined contribution (DC) plans to replace DB plans as the primary retirement benefit for public employees. A number of myths and misperceptions surround this movement; through this paper, NASRA seeks to address and clarify some of the more popular misunderstandings and misrepresentations about these plan types.

Financial planners have long referred to an ideal mix of retirement income sources as a “three-legged stool,” with one leg each representing Social Security, personal savings, and an employer pension. Although not every worker attains it, a well-balanced three-legged stool is a sensible personal financial planning strategy; an important component of an employer’s benefits package; and a sound public policy objective. Without an employer pension, there can be no three-legged stool. (In states that do not participate in Social Security, pension benefits for public employees typically are adjusted upward to compensate for the absence of Social Security benefits.)

Most public employers offer a voluntary DC plan, such as a 457 or 403(b) that supplements the DB plan. These types of

DC plans, which function like a 401(k) plan, are tax-deferred and can fulfill the personal savings piece of the three-legged stool.

NASRA believes that a DB plan should constitute an employee’s basic retirement plan, and should be supplemented by a voluntary DC plan. A 1998 NASRA resolution said, in part:

“ ... NASRA supports the prevailing system of retirement benefits in the public sector, namely, a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings; ... NASRA supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features sought by advocates of wholesale conversion.

Policymakers, taxpayers, and others with an interest in public employee benefits are well-served when the discussion about DB and DC plans is based on facts and a clear understanding of these plan types and the way they function.



NASRA White Paper

The Myth: “The public sector should convert from defined benefit to defined contribution plans, as the private sector has.”

Summary

Defined benefit (DB) and defined contribution (DC) plans each offer their own advantages and disadvantages. NASRA believes that employers should take advantage of both plan types by offering a DB plan as the primary retirement benefit, supplemented by an optional DC plan.

The implication that government should follow the lead of the private sector in adopting DC plans overlooks important differences between private and public DB plans and the reasons that some private sector plan sponsors have adopted DC plans. This implication also ignores the resilience DB plans have exhibited among many private sector employers.

Analysis

A closer examination of the private sector trend toward DC plans reveals not only that the extent of this trend is not as great as implied by many advocates of DC plans, but also that many of the factors driving the change toward DC plans are largely irrelevant to the public sector. For example:

- State and local government pension plans are exempt from most of the laws and regulations, known as ERISA, that govern private sector DB plans. ERISA imposes a substantial cost and administrative burden on employers that sponsor a DB plan, and accounts for much of the private sector movement toward DC plans.
- Virtually all the decline in the number of private sector DB plans has occurred among small employers – those with fewer than 250 employees. A majority of

large private sector employers continues to offer a DB plan. This is likely attributable to the economy of scale large employers enjoy, enabling them to incur the cost and burden of providing a DB plan; and to the relative ease and low cost of establishing a DC plan.

There are good reasons for employers to retain a DB plan as the primary retirement benefit for public employees:

- A DB plan is an effective tool for recruiting and retaining quality employees. Government’s exemption from most federal pension laws creates a rare competitive advantage for state and local government employers.
- Providing a DB plan helps assure a secure source of income for retired employees, reducing the likelihood of these employees relying on public assistance during retirement.
- By creating an incentive to retire, DB plans can facilitate an orderly transition of employees whose effectiveness or productivity may have waned. DC plans provide no such incentive, and may, in fact, serve as a disincentive.

Legal and Regulatory Changes

Analysts attribute much of the increase in the number of DC plans in private industry to ERISA, the Employee Retirement Income Security Act, which became effective in 1975. ERISA established standards for DB plan participation, vesting, retirement, and reporting; and imposed a tax on DB plans to fund the Pension Benefit Guaranty Corporation (PBGC). State and local government pension plans are not subject to

most ERISA regulations, and public plans are not required to make payments to the PBGC. As a result, the primary factor—ERISA—driving the private sector toward DC plans does not apply to state and local government plans. In lieu of ERISA, public pension plan sponsors (state and local governments) establish their own governing standards and rules. One beneficial outcome of this arrangement has been a wide range of policies and benefit structures, each suited to the unique needs of their plan sponsors.

ERISA amendments, particularly the Multiemployer Pension Plan Amendments Act of 1980, the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1986 – reduced or eliminated incentives to private sector employers offering DB plans, and increased the liability, expense, or regulatory requirements of maintaining a private sector DB plan. The rate of decline in the number of private sector DB plans was considerably more pronounced in the years immediately following these tax law changes, than it has been since.

Evidence suggests that recent legislative changes are encouraging a return of DB plans to smaller private sector businesses. According to *Plan Sponsor*, starting in the late 1990's, Congress relaxed some restrictions on DB plans. For example, in 1999, Congress eliminated contribution limits under section 415(e) of the tax code, which had restricted tax-deferred contributions and pension accruals for pension participants when a plan sponsor offers both a DB and a DC plan.

Large vs. Small Employers

Enactment of ERISA and subsequent amendments have especially affected smaller employers, which is where the vast majority of the reduction in DB plans has taken place. But most large employers continue to use DB plans. 346 of the S&P 500 offer DB plans as their primary

retirement plan. A recent Watson Wyatt analysis¹ of Fortune 100 companies, which are many of the nation's largest employers, found:

- 50 percent provide a DB plan as their primary retirement plan option; of these, most offer a supplementary 401(k) plan.
- One-third offer a “hybrid” plan, which combines elements of DB and DC plans.
- Only 17% offer a DC plan as their primary retirement benefit.

This survey also found that during the two-year period 2000-2001, the trend away from DB plans virtually stopped, and the number of companies offering a DC plan as the primary retirement benefit held steady. This trend is consistent with other studies indicating that most of the reduction in private sector DC plans during the past 25 years took place among smaller employers, and in the wake of the enactment of ERISA and subsequent amendments.

The Watson Wyatt survey also is consistent with the findings of an EBRI study that found that since 1985, the number of employers with 10,000 or more employees offering a DB as their primary retirement plan has actually *increased*.² That this increase has taken place during a period of many corporate mergers of large firms (which reduces the total number of employers in this category) makes it even more notable.

Most public sector employees work for governmental entities that are large

¹ “Trend Toward Hybrid Pensions Among Largest U.S. Companies Slows Considerably,” Watson Wyatt, May 3, 2002

² David Rajnes, Employee Benefit Research Institute tabulations of 1985, 1993, and 1998 Form 5500 annual reports filed with the Internal Revenue Service, “An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans,” September 2002

employers, and government as an employer should be compared with large private employers. A majority of these employers continue to offer DB plans to their employees. While many factors determine the type of retirement benefit an employer provides, these large private employers recognize the important role a DB plan plays in attracting and retaining quality employees.

As an employer, government has an opportunity to directly affect the retirement income security of its employees and to exploit one of the few competitive advantages government enjoys over private sector employers. Providing a benefit that assures workers a level of retirement income that is consistent with their tenure and salary is an effective way to exploit this advantage.



NASRA White Paper

The Myth: “DC plans are better because they offer greater portability than DB plans.”

Summary

DC plans do offer greater portability than DB plans. Unfortunately, this often leads to less retirement income security, not more.

Studies and experience show that a majority of terminating employees with a DC plan as their primary retirement benefit, cash out their assets rather than rolling them to another retirement plan. Retirement assets that are cashed out usually are subject to federal and state taxes and sometimes a penalty. Cashing out retirement assets defeats the purpose of having a retirement plan, yet DC plans provide little defense against such “leakage” of retirement assets.

An important objective of providing a retirement benefit is to retain quality employees. DC plans do not support this objective because they do not reward or encourage longevity. Because DB plans do reward longevity, they are an important element in retaining quality employees.

Analysis

Rather than make a wholesale conversion from a DB to a DC plan, many DB plan sponsors have responded to the needs of short-term, mobile, and other employees seeking portability, by providing a voluntary, supplemental DC plan option and by increasing the portability features of their DB plan. In fact, DB plan sponsors have incorporated a remarkable range and variety of innovative portability features, while preserving the core features of a DB plan. In doing so, DB plan sponsors provide a retirement benefit that offers the best features of both plan types.

Following are some examples of the flexibility and portability that state and local pension plans have added to DB plans during the past decade:

- Reduced vesting periods
- Paying to terminating or retiring employees all or part of the employer’s contributions
- Paying interest on distributed employee and employer contributions
- Sharing investment gains with participants
- Matching employees’ contributions to a supplemental DC plan
- Adding alternatives to the traditional life annuity payment options made to terminating and retiring employees
- Allowing hardship withdrawals
- Allowing members receiving a pension to continue working or to return to work
- Service purchase options that feature:
 - a variety of types of service for which credit may be purchased (e.g., other public service, service only in the same state, non-public service, etc.)
 - purchase of service using pre-tax dollars
 - availability of installment payments and automatic payroll deduction to purchase service
 - direct transfers of service credit from one retirement plan to another, in lieu of payments
 - allowing other retirement assets, such as those in 457 and 403(b) plans, to purchase service on a pre-tax basis
- Establishing and expanding deferred retirement option plans (DROP), that

allow members who qualify for retirement to continue working while accumulating assets in a separate retirement account

- Incorporating a “deferred augmentation” feature, which grows pension benefits for participants who terminate prior to reaching retirement eligibility.

Reduced vesting periods

One concern DC advocates have cited about the lack of portability in DB plans is their long vesting period. Ten years ago, a majority of public pension plans had a vesting period of ten years. This has changed: one of the more notable trends among public DB plans during the last decade has been the reduction in vesting periods.

According to the Wisconsin Retirement Research Committee’s *2000 Comparative Study of Public Retirement Systems*, a biannual survey that compares features of 85 of the largest public pension plans in the United States, “[t]he trend appears to be toward five-year vesting or shorter, perhaps reflecting federal [ERISA] vesting requirements that apply to private pension plans.” Including changes made since publication of the Wisconsin report, 58 of the study’s 85 plans (68%) have vesting periods of five years or less.

Service purchase options

Service purchase provisions accommodate workers who move from one employer to another, or who terminate and “cash out” their assets, then return to work with the same employer or one with the same retirement plan. A service purchase plan allows these employees to purchase retirement service credits in their DB plan.

The expansion of service purchase provisions has been a leading legislative trend affecting public pension plans during the past decade. More than two-thirds of the plans participating in the 2001 Public Pension Coordinating Council (PPCC) *Survey of State and Local Government Employee Retirement Systems* offer some

type of service purchase option, and of the plans that do not offer service purchase, nearly half are dedicated to firefighters, police officers, or judges, whose members are predominantly career employees or who are less likely than other employee groups to terminate prior to retirement.

Other examples of DB plan flexibility and portability

During the past decade many large public DB plans have incorporated a variety of features increasing flexibility and portability, while retaining DB plan features. For example:

- Most new public employees in Washington state now participate in a hybrid plan, in which the employer funds a DB benefit more modest than that provided to longer-tenured employees, and the employee contributes to a DC plan.
- The Arizona State Retirement System offers participants with five or more years of service a portion, up to 100%, of the matching contributions made by their employer. Terminating employees with five years of service are entitled to 25% of the employer contributions made on their behalf, rising to 100% for terminating employees with ten or more years of service. Participants terminating with less than five years of service receive their contributions plus accrued interest.
- The Colorado Public Employee Retirement Association matches fifty percent of employee contributions withdrawn by non-vested employees who terminate.
- Many states provide an employer match to employee contributions made to a supplemental DC plan, such as a 457 or 403(b).
- Participants in the Public Employee Retirement System of Idaho share a portion of the system’s investment gains, which are deposited into individual DC accounts. Participants may make also

elect to make contributions to these DC accounts.

- The Wisconsin Retirement System and Ohio PERS provide a hybrid retirement benefit, basing participants' pension on a combination of DB and DC plans.

These are just a few of many examples of public DB plans offering flexibility and portability while retaining the central feature of a DB plan: a guaranteed source of retirement income that reflects the worker's salary and length of service.

Portability caveat

An important concern about retirement plan portability is that many terminating employees do not transfer their retirement plan assets to another plan, such as an Individual Retirement Account or a future employer's plan. Studies indicate that a majority of terminating DC participants spend their retirement savings rather than rolling them into other retirement accounts.

A good example of terminating participants spending, rather than saving, their retirement assets is in Nebraska, where state and county government employees historically have participated in a DC plan. A recent study of the Nebraska Public Employees Retirement System, conducted by a national actuarial

consultant, found that 68% of terminating participants cashed out their assets rather than rolling them over to another retirement plan. This finding is consistent with a Hewitt Associates study which found that more than two-thirds of participants terminating from DC plans cash out their lump sum distributions rather than rolling them to other retirement accounts.

Such "leakage" of retirement assets from individuals' retirement accounts increases future costs of providing retirement. This is because the assets that are spent, rather than saved and invested, must be restored eventually, either by the employee or the employer, or both.

In testimony before Congress, the president of the Employee Benefits Research Institute, said: "Preservation (of retirement assets) in the presence of portability is, in my mind, the largest single issue in the system today in terms of determining how much money will actually be available to provide retirement income in the 21st century. ... Policymakers cannot fairly assess the portability issue unless they fully consider the consequences of money leaving the system versus money staying within the system."³

³ "The Future Role of Pensions in the Nation's Retirement System," Tuesday, July 15, 1997 - Panel Discussion General Accounting Office Conference Retirement Income Security in the 21st Century



NASRA White Paper

The Myth: “DC Plans are better because they allow employees to manage retirement assets themselves”

Summary

Some employees do wish to manage their own retirement assets, and most DC plans not only allow, but require participants to manage their retirement assets. DC plans also shift the risk of managing retirement assets from the plan sponsor to individual participants. Unfortunately, most employees are at best mediocre investors, unlikely to generate an investment return that will ensure an adequate level of retirement income.

DB assets have a longer time horizon, enabling them to withstand market volatility better than individuals. DC investors have a shorter investment horizon, requiring them to hold a more conservative portfolio, which leads to lower returns and less retirement income.

NASRA believes that a DB plan should constitute an employee’s basic retirement benefit, and should be supplemented by a voluntary DC plan. This arrangement satisfies the objective of providing a guaranteed pension benefit, while giving employees, especially those wishing to manage their own assets, the opportunity to save and invest in accounts they manage and direct.

Analysis

A key difference between DC and DB plans is that DC plans provide the opportunity to create retirement wealth, while DB plans provide income security. The purpose of a retirement plan is not to empower employees, or to create sophisticated investors, or to make participants wealthy. The chief purpose of

a retirement plan should be to promote financial security in retirement.

Requiring individual employees to bear the entire risk of assuring an adequate level of retirement income ignores the fact that most employees lack the knowledge of investment concepts and practices needed to succeed. When employees fail to save enough for retirement, they and their dependents may face indigence in their elder years and may be required to work in retirement. Some will become dependent on the state for public assistance.

The eighth annual John Hancock Financial Services Retirement Survey⁴ of DC plan participants, published in May 2002, stated “many have a cockeyed view of how investments work across the board.” John Hancock researchers said most DC plan participants will fall well shy of the estimated 75% of pre-retirement income needed to maintain the same lifestyle in retirement. The survey also documented numerous examples of ignorance of basic investment principles among DC plan participants.

The Nebraska Public Employee Retirement System had a similar experience. Despite considerable, sustained efforts to educate participants, public employees in Nebraska were directing 90% of all contributions to just three of the eleven available fund choices, and more than 50% of the DC plan assets were invested in the stable value fund.

⁴ “Eighth Annual John Hancock Financial Services Retirement Survey,” January 2002

A 2003 Pension Research Council Working Paper found that “a significant group of workers lacks the psychological attitudes or interests needed to maximize retirement security.”⁵

The Investment Company Institute reported in 2004 that one-half of all 403b plan assets (owned primarily by public employees) were held as annuity reserves in life insurance companies. Another 30 percent was held as variable annuities with mutual fund companies.

DB assets are invested on the basis of a long time horizon, enabling them to be invested more aggressively than DC assets, resulting in higher long-term returns. By contrast, DC participants, who are not professional investors and as a

group tend to be risk-averse, must assume increasingly conservative allocations as they near retirement, resulting in lower returns during both their working years and in retirement. The long investment horizon and professional investment of DB assets generate higher returns that compound, creating substantially greater returns over the long-term.

Ninety percent of public employees participate in a DB plan, and a supplemental, voluntary DC plan is available to nearly all public employees. NASRA believes this arrangement accommodates those employees who wish to manage their own assets, while still assuring a pension benefit for all participants.

⁵ “‘Money Attitudes’ and Retirement Plan Design: One Size Does Not Fit All, MacFarland, Marconi and Utkus, Pension Research Council Working Paper 2003-11



NASRA White Paper

The Myth: “An employee must spend his entire career with the same employer to benefit from a defined benefit plan.”

Summary

DB plans reward workers who remain with their employer long enough to become vested members. DB plans are intended to reward long-term employees: encouraging longevity among quality employees is a primary retirement plan objective—one that DB plans help promote, and that DC plans do not.

However, an employee does not need to spend his or her entire career with the same employer to benefit from a DB plan. A DB plan provides a guaranteed retirement payment for vested participants; in most public retirement plans, vesting takes five years or less. Many public retirement plans allow participants to transfer or purchase service credit from other plans. Most public plans pay interest on participant contributions, and some entitle terminating participants to their employer contributions.

Depending on the age of the participant when beginning and terminating employment, a DB plan can provide a retirement benefit that is greater than the benefit from even a well-invested DC plan, even for employees who work only for a short period of time.

Analysis

By rewarding longevity, DB plans assist employers in retaining

quality employees and encouraging longevity. This feature is especially helpful in the public sector, where salaries often lag behind the private sector, requiring employers to compensate in other ways. One of the chief arguments in favor of DC plans—their portability—can work against employers seeking to retain quality employees.

Yet it is misguided to believe that a DB plan benefits only those who spend many years or an entire career with the same employer. A chief strength of DB plans is that they offer participants a guaranteed retirement benefit funded with assets that are professionally invested.

By contrast, the benefit created by a DC plan is uncertain, determined largely by the participant’s investment decisions and ability to resist cashing out retirement assets prematurely. These are uncertain factors on which to base a worker’s retirement income security. When a DC plan is an employee’s primary retirement benefit, such uncertainty may fail to fulfill the purpose of a retirement plan for both the employee and the employer.

Even for long-term employees, a DC plan provides no assurance of a retirement benefit that exceeds or

even meets the benefit provided by a DB plan. This is because DC plans place the investment risk on the employee, and employees whose investment returns are sub-par over the course of a working life are likely to experience a lower retirement benefit than under a DB plan. The chapter *Employees want to manage their own retirement assets* addresses the likelihood of the typical DC participant achieving an investment return high enough to generate sufficient retirement savings.

Differences in benefit levels provided by DB and DC plans vary, and are determined by many factors, including the age of the employee when entering service. For example, assuming typical contribution rates and rates of investment return, an employee beginning a job at age 50 is better off in a typical DB plan regardless of how long he or she works. An employee entering service at age 45 will be better off in the DB plan after five years of service. This trend continues down the age scale—the younger the employee, the more time a DB plan needs to be relatively advantageous.⁶ This analysis is based on the

attainment of investment return assumptions and the use of lump-sum distributions, two factors that endanger long-term retirement income security.

The chapter on portability addresses the growing use of service purchase provisions, which allow employees who move from one state to another to transfer their DB service credit with them. Similar provisions permit employees who terminated and cashed out their DB assets in previous years, to purchase those back when they re-enter employment. These and other public plan provisions accommodate employees who relocate or who move in and out of public employment.

Today's workforce is older than it was twenty years ago, and older workers are more aware of their retirement income needs. This awareness promotes an understanding of and appreciation for DB plans. A DB plan helps employers, including government, to recruit and retain quality employees in today's competitive labor market.

⁶ORP Alternatives, Gary Findlay, presented to The Southern Conference on Teacher Retirement, 5/24/00



NASRA White Paper

The Myth: “Public employees in defined benefit plans need to worry about politicians mishandling their funds, creating unfunded liabilities, and cutting benefits.”

Summary

Defined benefit public pension funds are trusts, typically administered by a governing board whose members are fiduciaries, or by a sole trustee who serves as a fiduciary. Every state has established prudence standards to govern the investment and management of assets, and most public pension plan administrative officials typically prepare financial statements in accordance with generally accepted accounting principles that are subjected to independent audits in accordance with generally accepted auditing standards.

Federal constitutional provisions governing contracts and property rights are generally perceived to protect pension benefits from diminution. In addition, some state constitutions explicitly prohibit reductions in pension benefits; most other states employ statutes or case law to prohibit or limit efforts to reduce public employee pension benefits.

A legislature wishing to reduce retirement benefits can do so more easily under a DC plan than with a DB plan. DB plans have liabilities for which plan sponsors are responsible; DC plans do not.

Further, the idea that public employees must worry about elected

officials creating and then ignoring unfunded liabilities is not realistic. Typically, political jurisdictions are legally obligated to pay off any unfunded the liabilities of the DB plans within their purview. Any jurisdiction not responsibly financing its DB plan ends up with a net-pension obligation that must be disclosed in the plan sponsor’s financial statements. Accordingly, plan sponsors are motivated to ensure that plans are properly financed, because disclosure of a net pension obligation can negatively impact a jurisdiction’s credit rating.

Analysis

Mishandling Public Funds

First, once contributed to the pension trust, they are no longer “public funds.” The ability of elected officials to “handle” public pension funds is very limited. Most members of pension plan governing boards are appointed, not elected officials, and many are also members of the plan. All pension plan trustees are fiduciaries, including those who are elected officials, and are subject to fiduciary standards. An overarching theme of fiduciary standards is that the fiduciary must carry out his or her duties in the sole interest of plan participants, consistent with applicable laws, regulations, and policies.

In every state, fiduciary standards that govern the investment of assets include either a prudent person rule, a prudent investor expert rule, or a blend, or a variation of one or both.

The prudent person rule states that the fiduciary “is under a duty to the beneficiary to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived...”⁷

The prudent expert rule, prescribed in ERISA as the standard for private sector pensions, requires that the pension plan fiduciary discharge the duties of that position “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

None of the standards permit elected officials to “mishandle” public trust funds.

Creating Unfunded Liabilities

Simply expressed, states are responsible for covering the liabilities of the pension plans they sponsor. An unfunded liability is the result of the actuarial cost of benefits (liabilities) exceeding the actuarial value of assets. Elected officials can create an unfunded liability by authorizing benefits without providing immediate

assets sufficient to pay for them; by not making adequate contributions to the retirement plan; or by managing or directing investments that result in returns lower than the actuarially assumed return rate. If a legislature creates pension liabilities, the state is still legally required to meet its pension obligations.

Contradicting the assertion that public employees need to worry about elected officials creating unfunded liabilities, the overwhelming majority of state and local pension plan sponsors traditionally have made all required contributions to their pension plans. One result of this has been that public pension plans as a group have amortized their pension liabilities in a manner similar to how a homeowner pays off a mortgage. Public plans covering a large percentage of public employees are now fully funded, and plans covering most other employees are nearly fully funded.

Cutting Benefits

Most states protect public employees pension benefits through their constitution, statutes, or case law. Public pensions also enjoy protections provided through property rights law: “Under federal and state constitutional law notions of due process, property or a property right cannot be adversely impacted or taken by a governmental entity without observing procedural considerations. Pension benefit coverage and entitlement will

⁷ Calhoun and Moore, “Governmental Plans Answer Book,” Panel Publishers

generally be considered to be property bringing due process protections.”⁸

A DB plan actually is an effective vehicle for reducing the possibility of arbitrary benefit reductions, because inherent in a DB plan are liabilities for which the plan sponsor is responsible. If a legislature wished to

reduce future benefits for current or future employees, it would be easier to do so with a DC plan, as there are no employer liabilities associated with that type of plan. If “politicians cutting benefits” is a concern, a DB plan is a more effective means of preventing such actions.

⁸ Lawrence A. Martin, “Legal Obligations of Public Pension Plan Governing Boards and Administrators,” published by the Government Finance Officers Association



NASRA White Paper

The Myth: “DC Plans Cost Less than DB Plans”

Summary

Retirement plan expenses fall into one of two categories: administrative expenses, which include recordkeeping and investment management; and the cost of the benefit itself, reflected in the form of employer contributions. In almost every instance, the administrative cost of a DC plan is higher—often much higher—than that of a DB plan. The difference between these plan types is in who pays the administrative cost: the employer usually incurs most of the cost of a DB plan; the participating employee normally pays all or most of the administrative cost of a DC plan.

If an employer seeks to reduce the costs of its retirement plan by lowering contributions, the result will be a lower level of assets available for benefits. In addition, by diverting participants from an existing DB plan to a DC plan, DB plan costs in many cases will rise, and the employer will likely be required to continue to maintain its DB plan, mitigating or nullifying any expected budget savings.

Analysis

Administrative Costs

Although the administrative cost of each retirement plan varies, in almost every instance, DC plans cost more—usually much more—than DB plans. Two factors account for most of the difference in DC and DB plan

expenses. First, unlike DB plans, DC plans maintain individual accounts that are typically updated daily with information that is made accessible to the participant. Secondly, the size of DB plans covering most public employees creates an economy of scale, lowering the cost of administration and investment management.

Most DC plans use mutual funds or similar instruments as investment options. The average expense ratio for a stock mutual fund is around 1.5% of assets; the typical bond fund expense ratio is approximately 1.1% of assets. When costs for recordkeeping, participant education, and other administrative expenses are added, the annual cost of a DC plan can rise to as much as 2% of assets. This rate does not include the start-up costs needed to create a new DC plan; start-up costs generally are borne by the employer, either through expenses from the general operating fund or by drawing on assets from an existing retirement plan.

By contrast, a review of 12 of the nation’s largest public DB plans, which provide pension coverage for more than one-third of all active state and local government employees, found an average annual expense ratio of 0.25%, including costs for administration and investment management. Corroborating this finding is a California state law that

places a limit of 0.18% on the administrative expenses of county pension plans. When expenses are included for investment management and other activities outside the allowed limit, the total cost of these California county plans is well under one percent. Although smaller public pension plans are likely to have higher relative costs than larger ones, we can safely conclude that a substantial majority of public DB plans have an expense ratio that is considerably less than that of a typical DC plan.

Public DB plans are able to reduce their costs through economies of scale attained by their size, by negotiating favorable investment management fees, and in some cases by investing some assets using internal staff rather than external managers. Also, DB plans do not provide some services that drive DC plan costs higher, such as updating participant accounts on a daily basis and distributing quarterly statements.

Lower expenses have the same end result as higher investment returns. Higher returns increase the pool of assets available for pension benefits, and reduce required contribution rates. Higher investment costs have the opposite effect. Lower returns reduce the assets available for retirement benefits. For example, a DC plan with an expense ratio of 1.5% will reduce a participant's 8% investment return to 6.5%. Compounded over time, this difference will have a substantial negative effect on the value of a retirement account.

In his essay, *In Defense of the Defined Benefit Plan*, Gary Findlay presents the basic retirement benefit equation:

Reduced to its simplest form, the financial mechanism behind the operation of both types of plans may be described by the formula:

$$C + I = B + E$$

Where:

C = Contributions (employer, employee, or both)

I = Income from investments

B = Benefits paid

E = Expenses for plan administration

Findlay then explains the effects of expenses on each plan type:

In a conventional DB plan, the amount of 'E' will usually be a small fraction of a percent of the assets under management. The amount of 'E' will increase the amount of the employer's 'C', but will not have an impact on 'B'.

In a DC plan, with investment vehicles being individually selected by employees, it is not unusual for 'E' to be in the range of 1% to 2% of assets under management. The amount of 'E' will not affect the employer's 'C', but will have an impact on 'B'. (The greater the expenses, the less there is available for benefits.)

Findlay's formula is illustrated by the following example:

An employee begins working at age 25, and leaves his employer at age 35 with a retirement account balance of \$50,000. If this balance earns 8% (8.5% minus 0.5% for expenses) the account value will be \$437,000 when the employee reaches age 65. The same starting balance earning 7% (8.5% minus 1.5% for expenses) will have a value at age 65 of \$330,000, a difference of \$107,000, or 25% less.

A DB plan typically does not pay benefits on the basis of individual participants' account balance. However, the effect of higher fees is fundamental: they reduce the amount available for pensions and other benefits; or they increase required contributions.

Costs and consequences of switching from a DB to a DC plan

Attempts to reduce costs by replacing a DB plan with a DC plan are unlikely to produce the anticipated level of budget savings. As described by Cynthia Moore in *The Preservation of Defined Benefit Plans*, laws governing public pension plans generally protect pension benefits from diminution. This prohibition against reducing benefits requires a public employer to continue administering its DB plan at least for existing plan participants. If a DC plan also is established, the employer will need to administer both plans, limiting any budget savings.

Also, some methods used to value public pension plan liabilities rely on

continuous flow of new, younger members to help fund the cost of the plan's liabilities. For plans that use such valuation methods, diverting future employees from a DB to a DC plan can increase the cost of the DB plan.

One predictable consequence of a DC plan whose benefits prove inadequate is political pressure to create or revert to a DB plan. This situation recently occurred in Nebraska, where the DC plan failed to create a sufficient level of retirement income security for plan participants. Nebraska switched to a cash balance plan. Switching from a DC to a DB plan can result in shifting pension plan costs to future taxpayers, as insufficient pension accruals under the DC plan are funded.

DC plans offer certain advantages, including greater portability, the opportunity for participants to manage their own investments, greater access to account information, and a chance to directly benefit from investment returns that exceed market averages. But these advantages come with risks: investment risk that is borne entirely by the participant; the risk of leakage, when assets are cashed out and spent before retirement; longevity risk, when participants outlive their retirement assets; and the risk of diminished retirement savings as a result of high administrative expenses.



NASRA White Paper

The Myth: “Workers want a defined contribution plan as their primary retirement benefit.”

Summary

The reality is that most workers are unfamiliar with the differences between defined contribution and defined benefit plans. To the extent that employees have preferences for a retirement benefit, they are more likely to be for the *features* of the benefit rather than for a particular plan *type*; workers understand features like value, portability and flexibility, investment risk, and retirement income security.

A DB plan offers considerably more opportunity than does a DC to design a retirement benefit with features that are attractive to employees. In doing so, the DB plan facilitates a key objective for offering a retirement benefit: assisting employers in attracting and retaining quality workers.

As evidence of employee preferences for their retirement benefit, in recent years, when given the opportunity to choose between a DB and a DC plan, preponderant majorities of public employees have chosen the DB plan.

Analysis

Over the past two decades, many Americans have become familiar with the term *401(k) plan*. In the wake of more than three years of equity market declines and corporate accounting scandals, the 401(k) plan also is perceived as a risky and unreliable retirement benefit arrangement.

401(k) plans are only the most popular and recognized of several forms of defined contribution plans. Among public employees, 403(b) and 457 plans are common. Regardless of which plan type is available, recent equity market declines have heightened participant sensitivities about some plan features when a

DC plan is an employee’s primary potential source of retirement income. These pitfalls include:

- retirement plan account balances can decline, and sometimes they decline significantly
- these plans offer no assured retirement benefit
- plan assets can be exhausted well before death
- requiring amateur investors to make their own investment decisions can result in poor returns, even in a rising market
- market conditions at the date of retirement can significantly affect the level of retirement income available

The abstract notion, which may have peaked during the late 1990’s, that a DC plan can generate considerable wealth, has given way to a more sober and realistic perception that a DC plan by itself is an unreliable and precarious method for attaining retirement income security. Although DC plans have many positive attributes, this plan type is limited in its ability to include features that meet important employer objectives and that are attractive to employees.

By contrast, a DB plan design lends itself to extensive creativity to accommodate employer needs, including attracting and retaining quality employees. Some features that are attractive to employees and that can be designed into a DB plan include value, portability and flexibility, reducing investment risk, and increasing retirement income security.

Value

As with any other form of compensation, value is a primary consideration when assessing a retirement benefit. A worker's perception of value in a retirement benefit may take several forms, perhaps most notably the presence and size of an employer contribution, and some protection against loss of principal.

Nearly all DB plans offered to public employees provide an employer contribution; in some cases, public employers fund the entire cost of the DB plan. This increases the ability of employees to contribute to a supplemental DC plan account or other savings plan.

By definition, a DB plan protects participants' principal. Vested DB plan participants qualify for a retirement benefit that is assured regardless of market performance. By contrast, DC plans typically provide no protection against market losses: even the most generous employer contribution to a DC account can be eroded through poor investment returns.

Portability and Flexibility

This paper's chapter on portability highlights the progress DB plans have made toward providing portability to plan participants, including reduced vesting periods, distributing employer contributions to terminating participants, and paying interest on participant accounts.

DB plans also offer flexibility. For example, a growing number of DB plans feature PLOP's—partial lump sum option plans. A PLOP allows retiring participants to take a portion of their retirement annuity as a lump sum. DROP's—deferred retirement option plans—also make DB plans more flexible and portable by allowing employees to postpone retirement and accumulate a cash balance that supplements their retirement annuity.

Most DC plans offer more portability than DB plans. Yet as discussed in the chapter on portability, too much portability can damage

long-term retirement income security. Evidence shows that a majority of terminating participants cash out their DC plan assets, rather than rolling them into another retirement account. This defeats a fundamental retirement benefit objective—providing a source of retirement income.

Similarly, portability challenges retiring DC plan participants, as retirees have no assurance their assets will last the remainder of their lives. Retirees may spend all their assets at once, or at a rate that exhausts the assets well before their death.

In theory, *portability* and *flexibility* are salutary features of a retirement benefit, and to some extent, these features add value. Prudent retirement plan design, however, which considers the long-term retirement income security of plan participants, suggests there should be some limit on the extent of the plan's portability and flexibility.

A DB plan enables employers to balance the plan's portability and flexibility while protecting participants' long-term retirement income security needs. There are restrictions to offering such balance through a DC plan.

Investment Risk

The opportunity to manage their own retirement assets appeals to some employees. Most public employees have access to a voluntary DC plan that supplements their DB plan, enabling those who wish to manage a portion of their own retirement assets to do so.

As discussed in a previous chapter, most employees do not consider themselves to be knowledgeable about investments. Experience demonstrates that employees engage in a variety of practices resulting in investment returns that often fall well short of both market returns and returns of professional investment managers. This is a primary reason for NASRA's support of a DB plan as an employee's primary retirement benefit arrangement, supplemented by a voluntary DC option.

The Experience of Employee Choice

Since 1997, large numbers of public employees in Michigan, Florida, Ohio, and South Carolina have been given an opportunity to participate in a DC plan as their primary retirement benefit. The experience in these states creates a persuasive case study of employee retirement benefit preferences.

In each case except Michigan, the employer contribution equaled or exceeded the contribution to the DB plan; in Michigan, the employer contributes four percent of salary plus a matching amount of up to an additional three percent.

In each state, an overwhelming majority—more than 90%—of those eligible to switch elected to stay with the DB plan.

This experience is consistent with a survey conducted by the Ohio Public Employees Retirement System of its members with less than five years of service credit. The purpose

of the survey was to determine these employees' attitudes and preferences for a retirement benefit. The findings of Ohio survey included the following:

- When members were asked to rank the importance of 17 plan design features, the ability to direct money to a private investment company ranked 16 out of 17. Among the highest ranked features overall were portability, guaranteed monthly benefit after retirement, and health care coverage.
- A majority of members did not consider themselves to be knowledgeable about investments.
- More than half of the members surveyed (56%) expressed a preference for the DB plan, and an additional 32% said they would select the Combined Plan, which combines features of a DB and a DC plan. 6.4% said they would select the DC plan.



NASRA White Paper

The Myth: “Workers in defined contribution plans will receive substantially higher benefits than those offered by defined benefit plans.”

Summary

Although accumulating wealth is an admirable objective, the chief purpose of an employer-sponsored retirement plan is not to make workers rich. Rather, the central purpose of an employer-sponsored retirement plan is to promote workers’ retirement security.

Among participants whose primary retirement benefit is a defined contribution plan, some will, in fact, receive substantially higher benefits than they would under a defined benefit plan. However, many workers will fare worse under a DC plan, and some DC plan participants will have no retirement assets at all.

By providing an assured benefit whose value is known in advance of retirement, a DB plan meets the fundamental and imperative objective of a retirement benefit: to promote retirement security.

Analysis

Proponents of establishing a DC plan as workers’ primary retirement benefit contend that simple math illustrates a compelling argument in their favor: by calculating the contributions an employee and his employer will make during the employee’s working life, and factoring in projected investment returns, a DC plan will generate a larger annual benefit than would be available through a DB plan.

The problem with this argument is that it ignores decisions made by plan participants that can reduce and even eliminate the value of a DC plan. Some of these decisions are discussed in greater detail previously in

this paper, and are summarized briefly below.

Factors Limiting the Value of a DC Benefit

- Many DC plan participants “cash out” their retirement savings when changing jobs, instead of transferring those assets to another retirement savings plan. A recent study by Hewitt Associates found that 42% of 160,000 401(k) plan participants who terminated employment cashed out their assets, rather than rolling them to an IRA or to a future employer’s retirement plan. This paper’s chapter on portability presents substantial empirical evidence of pervasive “leakage” from retirement savings accounts.
- Most workers make poor investors, resulting in investment returns well below the level needed to ensure retirement security. The chapter on DC plan participants managing retirement assets themselves describes workers’ lack of knowledge and financial acumen necessary to generate investment returns anywhere near those assumed by DC plan advocates. The studies cited in this chapter describe a litany of harmful investment strategies engaged in by DC plan participants, such as taking on excessive or inadequate investment risk, market timing, borrowing from their retirement savings, and following trends, rather than establishing and staying with an appropriate asset allocation.

- Contrary to the theoretical models presented by DC proponents, every worker does not promptly enter the workforce in a full-time job after completing high school or college, and continue working until reaching retirement age. A substantial body of research has described the growth in so-called non-standard work arrangements, in which many jobs are seasonal, part-time, temporary, contract, or otherwise not permanent and full-time. The *2002 Census of State and Local Government and Payroll* found that state and local governments employed 13.8 million full-time employees and 4.5 million part-time workers. Whatever pension arrangements are in place for these part-time workers, their contributions are undoubtedly less than those implied in the models used by DC plan proponents.

Non-standard work arrangements are especially prevalent among workers under the age of 35, a time when making contributions and taking advantage of compound interest is critical to accumulating sufficient assets to ensure retirement security.

Similarly, many employees move into and out of the workforce for a variety of reasons, such as to have and raise children, for other family reasons, and for retraining or to increase their education. Some workers stop working before reaching normal retirement due to health reasons. In each of these instances, contrary to the assumptions of DC plan advocates, DC plan contributions are not being made.

Each of the factors listed above results in fewer assets available to plan participants at retirement. A worker who experiences one

or more of these factors is likely either to have lower benefits in retirement than those offered by a DB plan, or to be required to work longer than they would if a DB plan were their primary retirement benefit. The idea that DC plan participants will retire with higher benefits is simply untrue for many workers.

Effects of Longevity and COLA's

Even for a DC plan account with an initial retirement benefit that is greater than the benefit the worker would receive under a DB plan, there is good chance that the real purchasing power of the benefit will fall below that of a DB plan during the worker's remaining life. There is also a chance that the worker will outlive his or her assets.

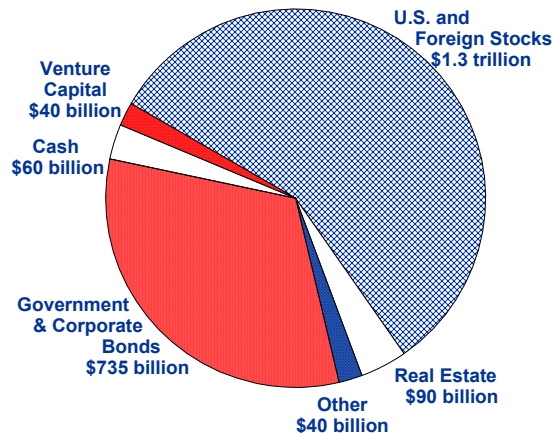
The median life expectancy of a 65 year-old American is 85. One-fourth of all women in America age 65 will reach 93; one-fourth of American men who are 65 will live to be 88. Most DC plans contain no cost-of-living provision. Yet, an annual inflation rate of 2.5 percent from age 65 to 93 will reduce the purchasing power of a retirement benefit by more than half.

Even worse than a benefit that is deteriorating due to inflation is a benefit that is exhausted before death. Yet this is a very real possibility for retirees with a DC benefit who live long enough, or who spend their assets quickly enough.

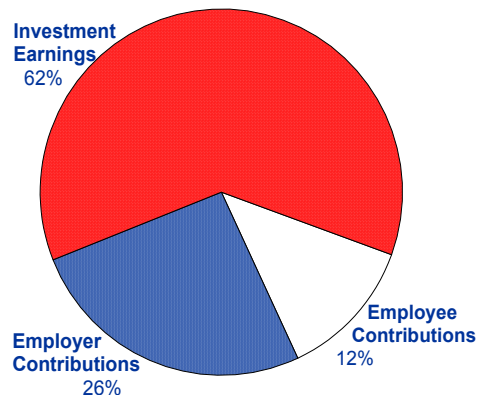
Thus, even in cases where a DC benefit initially exceeds the amount that would be provided by a DB benefit, that advantage is likely to disappear during a worker's retired life. For these reasons and others described throughout this paper, NASRA supports a defined benefit plan as a worker's primary retirement benefit, supplemented by a voluntary defined contribution benefit.

State and Local Government Defined Benefit Retirement Plans

- **Public Pension Plans are in Good Financial Condition.** As a group, state and local pension systems have nearly 90 percent of the funds required for each dollar they owe in liabilities. These assets are professionally managed and invested for the long-term based on sound investment policies. As shown on the following chart, the more than \$2 trillion (in real assets, not IOU's) held by these plans are an important source of liquidity and stability for our financial markets:



- **The Bulk of Public Pension Benefit Funding is NOT Shouldered by Taxpayers.** In fact, employer (taxpayer) contributions to state and local pension systems make up only one-fourth of revenues. Earnings from investments comprise the majority of public pension fund revenues. Unlike in the private sector, most public employees are also required to contribute to their pension plans. The chart below summarizes the sources of public pension revenue for the 20-year period ending in 2002:



- **Public Retirement Plans Attract and Retain the Nation's Essential Public Workforce.** There are more than 20 million working and retired state and local government employees. They live and work in virtually every city and town in the nation and comprise more than 10 percent of the U.S. workforce. Nearly two-thirds of the public sector workforce is employed in education, public safety, or corrections. Retention of experienced and trained personnel in these positions and many others is critical to sound delivery of public services.
- **State and Local Pension Plans are an Integral Component of National, State and Local Economies.** Public plans distribute \$120 billion annually in benefits to 6 million retirees, disability recipients and beneficiaries, with the average annual pension benefit equaling roughly \$18,500. These payments are vitally important to future economic growth. They are steady and continuous, increase with inflation, and provide a strong and locally-disseminated economic stimulus (most retired public employees live in the same area they worked). A 2004 study found state and local government pension distributions contribute 2.0 percent more to GDP (over \$200 billion more) than if they had been invested in self-directed 401(k)-type retirement accounts.
- **State and Local Plans are Subject to Comprehensive Oversight.** While private sector plans are subject solely to federal regulation, state and local government plans are creatures of state constitutional, statutory and case law and must comply with a vast landscape of state and local requirements. These plans are accountable to the legislative and executive branches of the state; independent boards of trustees that include employee representatives and/or ex-officio publicly elected officials; and ultimately the taxpayer public.
- **State and Local Pension Funds Earn Competitive Investment Returns.** For the 5- and 10-year periods ended 12/31/04, public pension funds earned 4.1% and 10.2%, compared to corporate pension plans' returns of 3.9% and 10.8%.



National Association of State Retirement Administrators

Overview of plan types and their use among statewide retirement systems

According to the U.S. Bureau of Labor Statistics, roughly ninety percent of state and local government employees participate in a *defined benefit* (DB) plan as their primary retirement benefit; *defined contribution* (DC) plans serve as the primary retirement benefit for most others. Some workers have a hybrid plan as their primary benefit; for purposes of this discussion, a hybrid is considered to be a form of DB plan. The summary below focuses on DC plans on a statewide level involving major employee groups: teachers, general employees, and public safety personnel.

Many of the 10 percent of state and local government employees with a DC plan as their primary retirement benefit are higher education faculty and staff, many of whom have been given an opportunity to choose between a DB and a DC plan. Also, a number of states provide a DC plan for selected, usually narrow employee groups, such as elected and appointed officials and unclassified or exempt staff.

This summary does not present a complete inventory of DC plans among state and local government employees. Although exact statistics are unavailable, most public employees participating in a DB plan also have access to a supplemental, voluntary DC plan. Such plans typically are identified by the

section number of the Internal Revenue Code authorizing them, for example, 457, 403(b), 401(a) and 401(k). These plans also are referred to as deferred compensation plans, tax-sheltered annuities (TSA's), and money purchase plans.

Some public employers provide as their workers' primary retirement benefit a hybrid plan, which incorporates elements of both DB and DC plans. Hybrids come in two basic forms: one form combines features of DB and DC plans into a single plan, and sometimes is referred to as a cash balance plan. This form provides a benefit based partly on the employee's length of service, as in a DB plan; and partly on the plan's investment return, as in a DC plan.

A different and more common form of hybrid is made up of two distinct and separate plan types: a traditional DB plan, normally with a lower multiplier; combined with mandatory participation in a traditional DC plan.

A 2003 resolution expresses NASRA's position that a DB plan should serve as an employee's primary benefit, and should be supplemented by a voluntary DC plan. This resolution also expresses NASRA's support for changes in this structure that accommodate many of the objectives supported by advocates of DC plans.

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Following is a summary of DC plans and recent changes in plan types affecting major state employee groups and of state employees with access to a DC plan as their primary retirement benefit:

- Most public employees in **Indiana**, including public school teachers and state employees, participate in a hybrid plan that provides a traditional DB plan with a retirement multiplier of 1.1%, accompanied by a DC benefit based on investment returns.
- The **Texas** County & District Retirement System and the Texas Municipal Retirement System provide hybrid plans that base benefits on a combination of service, contributions, and investment returns.

- In 1987, the **District of Columbia** closed its DB plan to new employees other than teachers and public safety personnel. Employees hired since October 1, 1987 participate in a DC plan plus Social Security.
- In response to severe actuarial underfunding, **West Virginia** in 1991 closed its DB plan to new teachers and created a DC plan in its place. In 2005, the state legislature reopened the DB plan to new hires and authorized DC plan participants to vote to switch to the DB plan.
- In 1995, **Washington** state created Plan 3 for new teachers and existing participants who elected to switch from the traditional DB plan. Plan 3 is a hybrid plan in which the employer funds a DB component with a multiplier of 1.0%, and the employee contributes to a DC account. New state and local government employees subsequently have been added to Plan 3.
- In 1997, **Michigan** closed its DB plan to new state employees. Existing plan participants were given the option to remain with the DB plan or to switch to the new plan. Approximately 94% of those eligible to switch stayed with the DB plan. In the new DC plan, the state contributes four percent plus matches the employee's contribution up to another three percent.
- **Ohio** created an optional DC retirement plan in 1998 for new education employees and those not yet vested (five years). Under this plan, new employees may choose from among three alternatives: a DC plan, the traditional DB plan, or a hybrid. These options were extended to teachers in 2001 and to state and local government employees in 2002. More than 95% of active, working state and local employees eligible to choose opted for either the traditional DB plan or the hybrid (combined) plan, with the vast majority of those electing to remain with the traditional DB plan.
- Beginning in 2000, new and current teachers and educational employees in **South Carolina** were given a choice to participate in a DC plan as an alternative to the DB plan; this option was extended to state and local government employees in 2002. Approximately three percent of those eligible elected to switch to the DC plan.
- Also in 2000, **Florida** established an optional retirement plan for all current and future FRS participants. This legislation allowed existing participants to make one of three choices: remain with the DB plan; switch to the DC plan but keep their existing DB service credit; or switch to the DC plan and transfer the cash value of their DB plan credit to their new DC account. Approximately 95% of existing employees elected to stay with the DB plan.
- New and existing employees in the **Montana** PERS were given a choice between the traditional DB plan and a DC alternative during a one-year open enrollment process that ended in June 2003. Approximately three percent of those eligible elected to participate in the DC plan.
- In 2002, in response to concerns that employees were not accumulating enough for retirement in their DC plan, the **Nebraska** Legislature established a hybrid cash balance plan for new state and county employees and existing DC plan participants who elected to switch.
- In 2003 **Oregon** established a hybrid plan for new Oregon PERS participants, in lieu of the traditional DB plan. The plan combines a DB component multiplier of 1.5% (1.8% for public safety personnel), funded by the employer, with mandatory participation in a DC plan, funded by the employee (unless the employer elects to make its employees' contributions).
- In 2004, **Colorado** established a defined contribution option for new state employees beginning January 1, 2006.
- In 2005, the **Alaska** Legislature closed the DB plan for most public employees in the state hired after June 2006, including school teachers and state employees.